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In the Supreme Court of the United States

CEMCO INVESTORS, LLC, AND
FOREST CHARTERED HOLDINGS LTD.,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

REPLY TO BRIEF IN OPPOSITION

THOMAS D. SYKES
MCDERMOTT WILL & EMERY LLP
227 W. Monroe St., 56th Floor
Chicago, IL 60606
(312) 372-2000

M. MILLER BAKER
Counsel of Record
PAUL M. THOMPSON
JEFFREY W. MIKONI
TIMOTHY S. SCHUMAN
MCDERMOTT WILL & EMERY LLP
600 Thirteenth St., N.W.
Washington, D.C. 20005
(202) 756-8000

Attorneys for Petitioners
(Additional counsel listed on inside cover)

August 19, 2008

Additional Counsel for Petitioners:

RORY K. LITTLE
HASTINGS COLLEGE OF
LAW (U.C.)
200 McAllister St.
San Francisco, CA 94102
(415) 565-4669

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REPLY TO BRIEF IN OPPOSITION

Rather than address Cemco's questions presented, the government dodges them by arguing that the decision below was decided on other grounds. The government's sidesteps, however, are unavailing.

Even though the Seventh Circuit did not discuss the first question presented in any detail, and the second at all, both questions were fairly preserved below, and both are implicated by the Seventh Circuit's decision. As such, the petition presents two critical questions to this Court—questions that the government has made no effort to persuade do not warrant this Court's attention on their own merits.

1. The Seventh Circuit determined that Treas. Reg. § 1.752–6 was permissibly retroactive as to the transaction at issue for two reasons.[1] First, Code Section 7805(b)(6) creates an exception to the norm of prospective application if there is a "legislative grant from Congress authorizing the Secretary to prescribe the effective date with respect to any regulation." 26 U.S.C. § 7805(b)(6). According to the Seventh Circuit, Congress did that in Section 309(d)(2) of the Community Renewal Tax Relief Act

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[1] Though the government also suggests that Cemco somehow conceded the applicability and retroactivity of Treas. Reg. § 1.752–6, both points were contested in the courts below. Pet. C.A. Br. 13–16; Pet. C.A. Reply 16 n. 15. The district court's contrary statement, upon which the government relies, is incorrect. Br. in Opp. 5 (citing App. 23, 25 & n.6).

of 2000, Pub. L. 106-554, 114 Stat. 2763A-587 (2000). *See* App. 6–7.[2]

Second, the Seventh Circuit held retroactive application was permissible because Cemco's transaction lacked economic substance. According to the court of appeals, the IRS always "has a statutory power to disregard transactions that lack economic substance," and "has considerable latitude in issuing regulations that specify sorts of transactions that may be looked through." App. 5. The court of appeals then explained that by issuing regulations on particular transactions that lack economic substance, the IRS "avoid[s] the need to litigate, one tax shelter at a time, whether any real economic transaction is inside the box." App. 5. With these fundamental assumptions in place, the court of appeals cited the Federal Circuit's decision in *Coltec*—a case interpreting the economic substance doctrine—in order to justify retroactive application of the regulation "because all the regulation does is instantiate the pre-existing norm that transactions with no economic substance don't reduce people's taxes." App. 7–8 (citing *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006)). In other words, because the transaction lacked economic substance, it was unnecessary to consider Cecmo's

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[2] Section 309(d)(2) of the Act provides that any regulations adopted under subsection (c) "shall apply to assumptions of liability after October 18, 1999, or such later date as may be prescribed in such rules[,]" thus vesting in the Secretary discretionary authority to promulgate retroactive regulations implementing Section 309 of the Act. *See* Pub. L. 106-554, 114 Stat. 2763A-587 (2000).

"complain[t]" that the regulation was *impermissibly* retroactive. App. 7.

The government argues that the second half of the Seventh's Circuit's retroactivity analysis—that it was unnecessary to even consider whether the regulation was permissibly retroactive because the transaction lacked economic substance—was mere dicta because Section 7805(b)(6) expressly authorized retroactivity. *See* Br. in Opp. 11. The government asserts, on its own *ipse dixit*, that the regulation is not subject to judicial review for abuse of discretion. *Id.* Instead, according to the government, "a reviewing court is limited to determining whether, as a matter of law, the regulation falls within the scope of the legislative grant of authority." *Id.*

In so arguing, the government seems to assume that the 1996 amendment to 26 U.S.C. § 7805(b) rendered obsolete decades of case law applying an abuse-of-discretion standard to the Commissioner's decision to make regulations retroactive—including retroactive regulations authorized by express legislative grants. *See, e.g., Anderson, Clayton & Co. v. United States*, 562 F.2d 972, 984–985 (5th Cir. 1977) (same abuse-of-discretion retroactivity analysis applies whether regulation is interpretative or legislative, *i.e.*, expressly authorized by statute); *Snap-Drape, Inc. v. Comm'r*, 98 F.3d 194, 202 (5th Cir. 1996) (applying four *Anderson* abuse-of-discretion factors to retroactive legislative regulation). This position is particularly striking given that, when revising Section 7805(b) in 1996, Congress reversed the statutory presumption of

retroactivity and replaced it with a statutory presumption against retroactivity—Congress *restricted* the Commissioner's discretion to make regulations retroactive to specifically enumerated circumstances. *See* H.R. Rep. No. 104-506, at 44 (1996) ("The Committee believes that it is generally inappropriate for Treasury to issue retroactive regulations.").

Not surprisingly, then, leading tax commentators agree that the abuse of discretion standard continues to apply to retroactive regulations issued pursuant to the express grants of authority contained in amended Section 7805. *See* Michael I. Saltzman, IRS PRACTICE AND PROCEDURE ¶ 3.02[4] (rev. 2d ed. 2007) ("These decisions and other case law on retroactive regulations still have relevance today."); FEDERAL TAX COORDINATOR ¶ T-10103.1 (2d ed. 2008) ("[B]efore July 30, '96, the current statutory rules regarding retroactivity of tax regs didn't apply, IRS had broad discretion to make regs retroactive and IRS's promulgation of retroactive regs was reviewable for abuse of discretion. The cases, etc. discussed below were decided under the pre-July 30, '96 law, and thus their applicability under current law is somewhat unclear. However, it would seem reasonable that the courts will continue to consider challenges based on the argument that the retroactive application of a particular reg represents an abuse of IRS's discretion under the statute.").

Indeed, in the court of appeals, the government *conceded* that retroactive regulations issued pursuant to the Secretary's specific authority under

Section 7805(b)(3) to prevent abuse were subject to judicial review for abuse of discretion:

> Prior to 1996, there was no statutory provision specifically authorizing the Secretary to promulgate retroactive regulations in order to prevent abuse. Instead, the Secretary was generally authorized to issue retroactive regulations, subject to judicial review for abuse of discretion. *See* 26 U.S.C. § 7805(b) (1994); *Gehl Co. v. Comm'r*, 795 F.2d 1324, 1332 (7th Cir. 1986).
>
> *Presumably, the Secretary's specific authority under § 7805(b)(3) to issue retroactive regulations in order to prevent abuse—an exception to the general prohibition against retroactive regulations effected by the 1996 amendment of § 7805(b)—is subject to judicial review for abuse of discretion as well.*

Resp. C.A. Br. 42-43 (emphasis added). Section 7805(b)(3), like Section 7805(b)(6), is a specific grant of legislative authority to issue retroactive regulations. If regulations issued pursuant to Section 7805(b)(3) are subject to judicial review for abuse of discretion as the government conceded below, then in principle so must regulations issued pursuant to Section 7805(b)(6).

The closest the Seventh Circuit came to engaging in this mandatory abuse-of-discretion analysis is its conclusory finding that Cemco "is

scarcely in a position to complain" about retroactive application of Treas. Reg. § 1.752–6, because the regulation merely "instantiate[d] the pre-existing norm that transactions with no economic substance don't reduce people's taxes." App. 7–8. As already stated, in reaching that holding, the Seventh Circuit relied upon *Coltec*—a decision that took a clear position in a deeply-entrenched circuit split regarding the proper understanding of the economic substance doctrine. Pet. 11–18. As the Seventh Circuit's retroactivity analysis is predicated upon its decision to adopt *Coltec*'s understanding of the economic substance doctrine, Cemco's petition properly challenges the court of appeals' economic substance analysis.

In other words, the court of appeals justified retroactive application of Treas. Reg. § 1.752–6 through its conclusion that the transaction violated the economic substance doctrine. If that conclusion was incorrect, as Cemco argues, then the Seventh Circuit's retroactivity analysis must fall.

2. The government's efforts to minimize the importance of the courts of appeals' disagreement regarding the proper scope of 26 U.S.C § 6662's valuation-misstatement penalty are similarly misdirected. The division among the circuits remains relevant, and Cemco's arguments before this Court are fairly embraced within its claims pressed below.

a. In order to avoid the import of the long-standing circuit split regarding the proper application of the valuation-misstatement penalty in

cases such as this, the government first seeks to frame the conflict as a relic of a bygone era, tied to a repealed prior version of the penalty statute. Br. in Opp. 12–13 ("The disagreement among the courts of appeals identified by petitioners actually concerns the scope of 26 U.S.C. [§] 6659 (1988), the now-repealed predecessor to Section 6662."). In doing so, the government unfairly downplays the textual similarity between modern Section 6662 and its predecessor.

Though the Omnibus Reconciliation Act of 1989 consolidated former Section 6659, along with other accuracy-related penalties, into modern Section 6662, the reorganization and recodification "carr[ied] over the same essential language." *Santa Monica Pictures, LLC v. Comm'r*, 89 T.C.M. 1157, n.191 (2005). Courts interpreting Section 6662's valuation-misstatement penalty have thus continued to apply the divided precedents that arose under prior versions, *see id.*, and no court has suggested that the division between the courts of appeals has been obviated by the statute's minor intervening amendments. Indeed, the government's suggestion that pre-amendment caselaw is no longer relevant to interpretation of modern Section 6662 stands in stark contrast to its arguments below, wherein it *relied* upon cases interpreting former Section 6659. *See* Resp. C.A. Br. 72 (citing *Gilman v. Comm'r*, 933 F.2d 143 (2d Cir. 1991)). There is no reason to believe that the circuit split regarding proper application of the valuation-misstatement penalty statute does not remain vital under 26 U.S.C. § 6662.

b. The government next insists that because Cemco did not adequately "press" its question presented below, Cemco's argument that the Seventh Circuit's decision implicitly deepens the split regarding proper application of Section 6662 "is not properly before this Court." Br. in Opp. 14. Yet the government concedes that "Cemco certainly pressed below its generalized claim that 'the IRS could not apply § 6662 against it,'" Br. in Opp. 14 (quoting Pet. 25), a statement well-supported by the record in this case. The district court understood the nature of Cemco's argument, stating that "Cemco's second amended petition challenges the valuation misstatement penalties on the basis that the underpayment of tax alleged in the FPAA is not *attributable to a misstatement of value*." App. 32 (emphasis added); *see also* App. 32–33 ("Because the underpayment of tax does not result from an incorrect valuation, Cemco contends, a valuation misstatement penalty cannot be imposed as a matter of law."). Cemco made the same assault on the application of the valuation-misstatement provision in the court of appeals: "[D]issallowance of the claimed loss (as determined by the IRS's FPAA) is *not attributable to an incorrect valuation*[.]" Pet. C.A. Br. 33 (emphasis added). Although Cemco did not cite below all the cases identified in the split presented to this Court, it unquestionably challenged the application of the valuation-misstatement provision. App. 32–33; Pet. C.A. Br. 33–34, 37.

Under this Court's jurisprudence, Cemco's arguments below are more than sufficient to support its petition. *See Lebron v. Nat'l R.R. Passenger*

Corp., 513 U.S. 374, 379 (1995) ("Our traditional rule is that 'once a federal claim is properly presented, a party can make any argument in support of that claim; *parties are not limited to the precise arguments they made below*.'" (emphasis added)); *see also Yee v. City of Escondido*, 503 U.S. 519, 534–535 (1992). In *Lebron*, the Court held that a party was free to argue that Amtrak was a part of the federal government even though it had "expressly disavowed" the argument below; the party's general "claim" was that Amtrak had failed to respect his First Amendment rights, and he therefore was free to raise a new argument in support of that claim before the Court. 513 U.S. at 378–379. Similarly, Cemco's claim—presented to both the district court and the court of appeals—is that the IRS cannot apply § 6662 to its transactions. The fact that Cemco's petition refines this argument is no barrier to this Court's review.

3. With these procedural concerns addressed, the government's Brief in Opposition makes no effort to discount the existence and importance of the questions presented by Cemco's petition, Pet. 10–28, nor does it undermine the fact that this Court's review is necessary to bring clarity and stability to two long-unstable areas of federal tax law, Pet. 29–31. Cemco will therefore not belabor that which the government has not contested: that the lower courts remain divided over two complex issues which warrant this Court's immediate attention.

CONCLUSION

For the reasons provided above and in the petition for a writ of certiorari, the Court should grant the petition.

Respectfully submitted,

THOMAS D. SYKES
MCDERMOTT WILL & EMERY LLP
227 W. Monroe St., 56th Floor
Chicago, IL 60606
(312) 372-2000

RORY K. LITTLE
HASTINGS COLLEGE OF LAW (U.C.)
200 McAllister St.
San Francisco, CA 94102
(415) 565-4669

M. MILLER BAKER
Counsel of Record
PAUL M. THOMPSON
JEFFREY W. MIKONI
TIMOTHY S. SCHUMAN
MCDERMOTT WILL & EMERY LLP
600 Thirteenth St., N.W.
Washington, D.C. 20005
(202) 756-8000

Attorneys for Petitioners

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